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Alternatives to Chapter 15 “Are They Really Necessary”

Saturday, February 7, 2009

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Alternatives to Chapter 15 “Are They Really Necessary”

OVERVIEW

In a less complex period of time during the 1900s, loans from financial institutions to businesses were relatively straightforward. A company requesting a loan from a financial institution would simply provide a loan application along with profitability and asset documentation. If the loan request met the criteria established by the particular financial institution the funds requested would be granted in exchange for an executed promissory note requiring repayment of such funds, with interest, as well as a pledge of certain assets as security. The financial institution was required to maintain adequate levels of capital and was subject to review and periodic inspection by regulatory agencies. This routine business practice was both predictable and transparent providing certainty in the market place. As companies began to expand their operations both on a domestic basis and internationally, cross-border trade and commerce became a meaningful source of revenue for companies. Also as the need arose, companies would establish physical operations in cross-border jurisdictions. The sale of goods to customers in overseas jurisdictions was often accomplished by the establishment of a letter of credit upon which the company could draw as goods were shipped. The patterns established and developed in cross-border transactions were again predictable and transparent.

As cross-border trade continued to expand however, credit transactions grew more complex. Expanded international trade increased competition among companies for customers. As a result credit terms were often modified to provide for the sale of goods on open account in lieu of the traditional letter of credit. Advancing to the present, as companies have become more entrenched in foreign regions, they have felt the impact of

financial difficulties befalling such regions. For example, the Asian financial crisis resulted in numerous conglomerates incurring substantial losses requiring those companies to reevaluate how they conduct business in cross-border markets. Many companies simply reverted back to letter of credit terms or, in the alternative, carefully reviewing and imposing more stringent credit terms and conditions for cross-border customers. As a result of such experiences, businesses that engaged in cross-border trade wanted uniform procedures for situations where outstanding obligations were not paid by the foreign company for goods or services rendered (especially where insolvency proceedings or commercial litigation resulted).

During the last ten to twelve years the dynamic of cross-border trade and related lending and investment structures has changed dramatically. In many cases the traditional financing structure of the past is not the predominant method utilized in current day transactions.

Traditional lending practices were superseded in many instances by new financial structures and mechanisms such as collateralized debt obligations, credit default swaps, derivatives, synthetics and hedge funds, all of which have become prevalent and changed the basic structure in the way in which business is conducted and investments are made.

As an example, loans to home buyers, especially in the United States, whose credit was sub prime or less than generally acceptable became the normal practice as opposed to the exception. Financial Institutions and investors were blinded by the higher returns and earnings sub prime loans were supposed to generate. Safety, soundness and adherence to previously well established loan policies became secondary concerns and were ignored or modified. Sub prime loans were made, bundled and incorporated into

what became known as collateralized debt obligations (“CDOs”). Billions of dollars of sub prime loans were made and sold as CDOs. Defaults dramatically increased, and the resultant charge-offs of the CDOs by financial institutions, investment banks and other third party players resulted in a substantial devaluation of the real estate market and ultimately in a world wide financial crisis.

CDOs were not acquired solely by U.S. investors. Numerous international financial institutions and investment firms acquired billions of dollars of CDOs. Several governments provided funding to keep financial institutions, insurance companies and investment companies afloat. To date, hundreds of billions of dollars have been committed for the rescue of such businesses, commonly referred to as bailouts. The losses have become so severe that several major long-standing financial investment firms, such as Bear Stearns and Lehman Brothers have faltered. Massive charge-offs and write downs, have shifted the market pendulum from a credit surplus to a credit shortage. Sub prime loans have evaporated, and lending requirements on real estate loans have retreated back to levels where adequate margins, sound credit and strong fiscal considerations were mandated.

In addition to CDOs, hedge funds,¹ although developed in the 1950’s, became prevalent in the last eight to ten years, and emerged as alternatives to traditional loans. Hedge funds managers are often compensated based on the percentage of assets under administration and upon receipts of profits above certain established and defined levels. A rule of thumb has often been referred to as the two-twenty rule which refers to a

¹ A specific definition of a “hedge fund” is extremely difficult as often there is no uniform purpose for which such a fund is created. Generally, however, a hedge fund can be described as a private, pooled investment vehicle managed by investment professionals and funded by qualified investors or institutions. Since hedge funds are composed of a limited number of qualified investors or institutions, they are generally exempt from compliance with securities laws and other disclosure and public reporting requirements.

payment for professional services of two percent (2%) of assets under management and twenty percent (20%) of profits above designated levels. Where traditional banks will extend credit and have a vested interest in the borrower, hedge funds develop strategies tailored to each investment which may be directly opposed - even hostile - to the interest of a borrower. For example, a hedge funds purpose may be to purchase pre-petition unsecured debt or pre-petition equity in order to liquidate the company to generate a profit. Hedge funds may also replace existing secured lenders either in pre or in post insolvency proceedings to take over the company if the debt obligations are not met. Finally, hedge funds may simply acquire debt and equity in order to effectuate a hostile take over of the company.²

Hedge funds also do not occupy the role of traditional unsecured creditors. Unlike unsecured creditors, hedge funds are generally not concerned with the ability of a company to continue its business operations to generate revenue from additional services rendered and received a return on credit previously extended. Thus, hedge funds, in and out of insolvency proceedings, have the flexibility to structure an investment in a company for a number of different purposes, including the acquisition of secured debt, unsecured debt or equity in contrast to the role of a traditional lender.

While previous traditional lending practices were easily comprehended and understood many of the current debt and investment structures are often misunderstood and their effects and consequences are not fully appreciated by most professionals.

The ultimate question is whether the existing international insolvency laws are adequately to deal with the very complex and highly unorthodox investment and

² See generally Hedge Funds: The New Masters of the Bankruptcy Universe, 17 J. Bankr. L. & Prac. 5 Art. 7, Rosenberg & Riela (August 2008).

financing structures that are being used by companies engaged in cross-border trade and commerce.

INSOLVENCY LAW REFORM ON AN INTERNATIONAL BASIS

Businesses have long recognized the need for uniform procedures in regard to business transactions throughout the world. In the past, such desires by businesses were acknowledged as impossible and not feasible. Over the last number of years substantial efforts and results have been effectuated in regard to law reform in cross-border insolvency proceedings.

On December 15, 1997, by Resolution 52/158, the General Assembly of the United Nations adopted the Model Law on Cross-Border Insolvency and Guide to Enactment (the “Model Law”). Since that date, the following fifteen countries have adopted the Model Law: Australia, the British Virgin Islands, Columbia, Eritrea, Great Britain, Japan, Korea, Mexico, Montenegro, New Zealand, Poland, Romania, Serbia, South Africa, and the United States. (Argentina, Canada, Ecuador, Germany, India, and Pakistan have expressed their intent to enact the Model Law.)

Prior to the enactment of the Model Law, the European Union adopted Council Regulation 1346/2000 (the European Insolvency Regulations”). Recital (13) and Article 3(1) which binds member states of the European Union to a uniform set of procedures in cross-border insolvency proceedings.

Both the European Insolvency Regulation and the Model Law were enacted with the goal of bringing uniformity, transparency and predictability to the otherwise murky area of cross-border insolvency proceedings. Many observers would undoubtedly agree that substantial progress toward that goal has been achieved. But issues have interfered

with and clouded that objective. The first is the lack of a clear, precise and uniform definition of what constitutes the centre of main interest (“COMI”) of the debtor and the second is the utilization of forum shopping in cross-border insolvency proceedings.

In order to better understand the impact of these issues on cross border insolvency proceedings it is necessary to look at several definitions from Article 2 of the Model Law. These definitions are as follows:

(a) “Foreign proceeding” means a collective judicial or administrative proceeding in a foreign state, including an interim proceeding, pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control of supervision by a foreign court, for the purpose of reorganization or liquidation. The next definition is foreign main proceeding which means (b) “Foreign main proceeding” means a foreign proceeding taking place in the state where the debtor has the centre of its main interests. (c) “Foreign non main proceeding” means a foreign proceeding, other than a foreign main proceeding, taking place in a state where the debtor has an establishment within the meaning of sub paragraph “f” of this article. (d) “Foreign representative” means a person or body including one appointed on an interim basis, authorized in a foreign proceeding to administer the organization or liquidation of the debtors assets or affairs or to act as a representative of the foreign proceeding. (e) “Foreign court” means a judicial or other authority competent to control or supervise a foreign proceeding. (f) “Establishment” means any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services.

In addition, Article 16 of the Model Law contains a presumption in paragraph 3 which needs to be also considered. Such presumption is as follows: (3) “In the absence of

proof to the contrary, the debtor's registered office, or habitual residence in the case of an individual, is presumed to be to the centre of the debtor's main interests." As noted herein, neither the European Regulation or its Model Law provide a definition for COMI. The above definitions and presumption contain the central provisions in regard to a determination of "COMI" in regard to the application of the European Council Regulation or the Model Law. As with any statutory or legislative provision a body of jurisprudence has developed to explain and further refine such definitions and implement and clarify the presumption as to debtor's registered office and the basis to determine when the presumption is superseded by proof to the contrary.

As noted, both the European Council Regulations and the Model Law envision a foreign main proceeding which is the primary proceeding and foreign non main proceedings which are secondary or ancillary proceedings.

Thus, if the debtor is operating in twenty states then the insolvency proceedings in one state will be designated as the foreign main proceeding based upon the debtor having a centre of its main interests in that state and the other states in which proceedings are opened will be foreign non main proceedings which are generally referred to as secondary or ancillary proceedings.

The European Regulation and the Model law contemplate multiple states having insolvency jurisdiction over a business with multi-national operations. To avoid inconsistent results, however, these laws also contemplate a primary jurisdiction. The "centre of main interest" is the imprecise term used to determine where the main business operations of the debtor are conducted.

Both the European Insolvency Regulation and the Model Law establish a presumption that COMI is presumed to be the debtor's registered office or, if the debtor is an individual, his or her habitual residence, but proof rebutting the presumption can be admitted to establish the debtor's centre of main interests are not in the state of the registered office. No definite provisions detail the scope or extent of the evidence that may be presented. When a debtor shops for a particular jurisdiction favorable to its insolvency objectives (commonly known as "forum shopping") while ignoring the debtors centre of main interests the effect is to undermine the transparency and predictability of cross-border insolvency laws.

For example, a debtor considers many factors before choosing where to file its initial insolvency proceeding, such as which jurisdiction would be most beneficial to the debtor in which to conduct the insolvency proceedings; whether such jurisdiction requires liquidation rather than reorganization; where labor laws and priorities allow the indebtedness due to laborers to be restructured and modified rather than where the rights of laborers are constitutional and cannot be modified which jurisdictions recognize the use of post-petition financing; and where jurisdictions allow the debtor to remain in possession and control of its business as opposed to those jurisdictions that require the appointment of a insolvency representative and displacement of the debtors ability to operate its business. Numerous other factors can be cited as a reason for a debtor to choose one jurisdiction over another as its initial choice of the filing of an insolvency proceeding. The debtor in determining the centre of its main interests may weigh the legal effects of an insolvency proceeding in that jurisdiction as opposed to another jurisdiction which may better meet the insolvency objectives of the debtor. This must be

a balanced test as the rights of creditors must be taken into account in making the determination of the debtor's centre of main interests. The debtor generally cannot complain of being subject to a state's jurisdiction for insolvency purposes as the debtor has previously voluntarily elected to conduct its business in that state. This consideration of an insolvency venue that best serves that objective is generally referred to as forum shopping.

Forum shopping is not per se an improper consideration but transparency and predictability in cross-border insolvency proceedings often come into conflict with the debtors choice of a favorable location to meet to the debtors insolvency objectives. The intent of both the debtor and its creditors must be considered in the determination of the COMI of the debtor. The European Council Regulations and the Model Law were designed with the concept of establishing and promoting predictability and transparency. In many cases, COMI is clear to both the debtor and creditor and there is no dispute as to COMI. But dispute arises when the debtor tries to maintain its centre of main interests in a state that is favorable to the debtor's interests but it is questionable as to whether COMI is in that state. It is like trying to put a square peg in a round hole and this is where forum shopping can become an abuse.

How judges or administrators determine the COMI of the debtor and, as a result, address the conflict between the provisions of insolvency laws and the Model Law with the debtors desire to choose a friendly jurisdiction is a complex one.

A related issue is a consideration of the time period to be used when determining the centre of main interests of a debtor. The determination as to what time period is utilized is relevant to a determination of COMI. If a debtor has his registered office in

France for twenty years and conducts its operations there and then moves its registered office and headquarters to the United Kingdom and files a voluntary proceeding in the United Kingdom, then the issue is where is the COMI of the debtor and what considerations are taken into account to make that determination.

For states not part of the European Union or that have not adopted the Model Law several alternatives exist. Debtors can file parallel proceedings in various jurisdictions and the insolvency representative or the respective courts can enter into protocols to coordinate the insolvency proceedings. UNCITRAL is in the process of developing guidelines regarding to the development and utilization of cross-border protocols to be used in parallel proceedings.

The importance of coordination in cross-border proceedings is critical. Article 25 and 26 of the Model Law provides for authority for cooperation and direct communication between courts in insolvency proceedings.

Many states have utilized comity as basis for recognition of the orders of a judge of a foreign court. This process generally requires a process in the state in which recognition is sought and consideration by the foreign court of the requested relief.

Regardless how ultimate jurisdiction over a cross-border insolvency proceeding is determined, however, history has demonstrated that the more predictable the outcome as to the enforceability of contractual obligations between parties, the more businesses desire to operate within that model.

COORDINATION OF INTERNATIONAL INSOLVENCY REFORM

During the last several years, UNCITRAL, the World Bank and the International Monetary Fund (“IMF”) have coordinated with each other to resolve any variances or

ambiguities between the World Bank Principles and the UNCITRAL Legislative Guide on Insolvency. In the view of the international community, harmonization has been effectuated and the World Bank Principles and the UNCITRAL Legislative Guide on Insolvency Law have been coordinated and harmonized. Many international insolvency experts acknowledge that the World Bank Principles and the UNCITRAL Legislative Guide on Insolvency Law taken together may well be considered to be the international standard on insolvency law when addressing insolvency law reform for businesses.

ADDITIONAL WORK BEING UNDERTAKEN BY UNCITRAL

UNCITRAL in after the development of Model Law and the Legislative Guide on Insolvency is now undertaking the development of a Legislative Guide on Insolvency is now undertaking the preparation of a Legislative Guide Enterprise Groups in Insolvency including, Cross-Border Post-Commencement Financing for Enterprise Groups, and the establishment of guidelines for Protocols between Courts.

GROWING JURISPRUDENCE IN REGARD TO THE MODEL LAW AND EUROPEAN UNION INSOLVENCY PROVISIONS

A growing body of jurisprudence has developed in both the European Union and in countries in which the European Insolvency Regulations Model Law are in force. A summary of some of the decisions will be helpful to understand how the courts in numerous jurisdictions have dealt with the definitions of foreign main proceeding, foreign non main proceeding establishment and the presumption of the registered office being its debtors centre of main interest in a determination as to the COMI of the debtor.

Currently there are various positions being taken in regard to what constitutes the centre of main interests of a debtor or COMI. One view is that the registered office

pursuant to the presumption should be the primary basis and the only basis for a determination of COMI. Other jurisdictions review the specific facts and circumstances of a debtor's operation to determine if the registered office is in fact the centre of the debtor's main interests or if in fact COMI is where the primary business operations are conducted, the primary decisions of the debtor actually take place and which location of the debtor is readily ascertainable by its creditors. This can be referred to as a form over function determination.

DAISY TEK- ISA LTD Ors³

Daisy Tek was a subsidiary of a United States corporation which filed a Chapter 11 reorganization proceeding in the United States on May 7, 2003. As a subsidiary of the U.S. corporation, Daisy Tek was a holding company of a number of European companies including three German companies and a French company. Daisy Tek was a processor for European resellers and wholesale distributors of electronic office supplies. Its operations in the United Kingdom were centered in Bradford, England. The three German companies had their registered offices in Neuss, Germany but actually conducted business operations from Freilassing, Magdeburg and Mulhain, Germany. The French company had its registered office and operated from facilities in France.

Daisy Tek commenced insolvency proceedings in the United Kingdom in 2003. The two primary issues before the English court were determining what was Daisy Tek's centre of main interests and whether the English Court had jurisdiction to make administration orders in regard to the French and German companies. The determinations were made pursuant to the European Union Insolvency Proceedings Regulation 1346/2000 under Recital (13) and Article 3(1). The English court ultimately determined

³ *Daisytek-ISA Ltd, Re* [2003] B.C.C. 562 (Ch D (Leeds District Registry), May 16, 2003).

that Daisy Tek's centre of main interests and of the French and German companies, was in the United Kingdom, and that the English court had jurisdiction to grant administration orders in regard to both the French and German companies. The court considered Recital (13) of the Regulation that the centre of main interests corresponds to the place where the debtor conducts the administration of its business on a regular basis and is therefore ascertainable by third parties. The court further recognized under Article 3(1) that the company's place of its registered office was presumed to be its COMI in the absence of proof to the contrary. The court in its decision determined the majority of the administration of the German companies was conducted from the Bradford head office, financing of the German companies was organized in the Bradford head office and seventy percent (70%) of the goods supplied to the German companies were supplied under contracts made by the holding company in Bradford. The court further found the functions carried out in Bradford were very significant and important and by comparison the local function of the companies in Germany was limited. The court made similar determinations regarding the French company.

The administration orders made in respect to the French registered company by the English court was initially greeted with disbelief and overturned by the Tribunal de Commerce of Cergy-Pontoise based on a conviction that the English court confused the notion of a separately incorporated subsidiary with a mere branch. On appeal however, the Court of Appeals of Versailles reversed the lower court decision, validating the opening of the main proceedings in England and the English Court's determination as to the location of the centre of main interests being in England. The French appeals court confirmed European Union Law that once an insolvency proceeding is opened by a

member state of the European Union then all member states must defer to the determination.

DaisyTek established a precedent in the European Union that once a member state opened an insolvency proceeding as a main proceeding the other member states of the European Union were bound by that determination.

The question arises is the better rule to have definitive criteria for the determination of a debtors COMI as opposed to factual findings by a court that mandate the result without established criteria for doing so.

Further, in the case of Rover France SAS,⁴ the Tribunal de Commerce of Nanterre in 2005 recognized the opening of foreign main proceedings by an English court for a French company operating and having COMI in Birmingham, England. This case also was appealed to the Court of Appeals in Versailles which upheld the recognition of the centre of the debtor's new interests being in the U.K. by the English court. The Court of Appeals however, found that it could not review how COMI was determined as that factual finding was already determined by another member state. Thus, European member states recognize that the initial opening of an insolvency proceeding in another member state and a factual finding therein regarding COMI preempted a subsequent and an independent determination as to whether COMI was properly determined.

The result in the Daisy Tek case is one under the European Insolvency Regulation. The initial insolvency proceeding filed and opened by its court will be in the main proceeding. The issues raised by this determination and practice is the lack of predictability which will result. If a non-traditional lender is considering investing or

⁴ SAS Rover France, Re [2005] EWHC 874 (Ch)

loaning funds to a company engaged in cross-border operations in Europe, one of the considerations must be the COMI of the debtor. If the company has operations in France, Italy and the United Kingdom the COMI of the debtor can drastically effect a lender or investor in that company. If the COMI is in Italy or France, very strong labor policies can drastically affect the priorities of a secured creditor, unsecured creditor or equity investor in an insolvency proceeding while if the COMI is in England the effect and consequences will be substantially reduced and the secured creditor, unsecured creditors and equity investor will be fore favorably treated with wage priorities being greatly reduced. So at this point of time when non-transitional loans, purchase of claims and equity investment may mean the difference between the liquidation or reorganization of the company. The COMI of the debtor if not properly ascertainable and predictable may result in an inability to obtain necessary financing or capital to remain viable.

With the world's economic crisis and the substantial restructure of credit being available to companies and further restriction as to the extension of credit caused by a lack of transparency and predictability as to a company's COMI will create more companies seeking insolvency relief and causing further economic chaos through loss of jobs, unpaid suppliers, and defaulted secured creditors.

EUROFOODS⁵

The basic concept of the initial determination of COMI by a member state being final was again challenged in the Eurofoods proceedings. Parmalat was a conglomerate head quartered in Italy, which operated in over thirty countries and employed over thirty

⁵ Eurofood IFSC Ltd, Re (C-341/04) [2006] E.C.R. I-3813; Eurofood IFSC Ltd (No.1), Re [2004] B.C.C. 383 (HC (Irl)); *see also* The Aftermath of "Eurofood" – Benq Holding BV and the Deficiencies of the ECJ Decision, *Insolv. Int.* 2007, 20(6), 85-87, Christopher G. Paulus

thousand employees throughout the world. After allegations of fraud were asserted against Parmalat various directors and professionals related to Parmalat were imprisoned by the Italian Government. On December 23, 2003, the Italian Parliament enacted a law providing for the “extraordinary administration” of Parmalat and its related subsidiaries, and on December 24, 2003, the Parmalat parent company was admitted to extraordinary administration proceedings in Italy and an extraordinary administrator was appointed.

Eurofoods was an Irish company whose primary business activity was to provide financing facilities for companies in the Parmalat group. Eurofoods was incorporated in 1997 and had its registered office in Dublin, Ireland. On January 27, 2004, a winding up petition for Eurofoods was filed by Bank of America before the Irish High Court which in turn appointed a provisional liquidator for Eurofoods. Thereafter the provisional liquidator notified the Parmalat extraordinary administrator of the Irish filing and his appointment. Notwithstanding the appointment for the provisional liquidator by the Irish court, on February 9, 2004, the Italian Ministry appointed the extraordinary administrator of Parmalat as the extraordinary administrator of EuroFoods in Italy. During the process each court independently determined that Eurofoods’s centre of main interests were in each court’s respective jurisdictions. The Irish court found COMI in Ireland since Eurofoods was incorporated and had its registered office in Dublin. This court further found that Eurofoods was subject to supervision by the Irish Minister of Finance and the taxing authorities of Ireland and its administration was conducted pursuant to a management agreement with Bank of America in Ireland, its annual accounts were prepared and audited in accordance with Irish law and accounting principles, its books of account were maintained in Dublin, its auditors were Irish, and Eurofoods had two Irish directors and

two Italian directors and that both of the Italian directors resigned prior to the winding up petition being filed. The Italian court likewise found COMI in Italy since, among other things Eurofoods was a subsidiary of Parmalat, that the directors of Eurofoods were mandated by Parmalat and all decisions regarding Eurofoods's operation were conducted and determined in Italy by the parent company. The respective decisions were appealed to the highest courts in Ireland and Italy, and both courts affirmed the determination of their lower courts that each respective country was the centre of Eurofoods' main interests.

The matter was then appealed to the European Court of Justice, which was created in coordination with the European Union as a commercial court to decide commercial disputes between member states. Thus, the European Court of Justice had jurisdiction to render a final determination as to whether Eurofoods's COMI was in Italy or Ireland.

The ultimate determination by the European Court of Justice was that Eurofoods's COMI was in Ireland. The European Court of Justice based its decision on several factors, including that insolvency proceedings were initiated and first opened in Ireland, Eurofoods's registered office was in Ireland and the presumption that the centre of its main interests is where the registered office is located had not been overturned.

Although Parmalat consisted of a group of a group of companies with global operations, the European Court of Justice centered on Eurofoods as a single and separate company in determining COMI rather than determining COMI for the entire Parmalat group.

The Eurofoods decision by the European Court of Justice stands for the determination that the court in which the insolvency proceedings are initially opened

shall control as to a determination and the COMI of the debtor. The Eurofoods decision buttressed and supported the determinations made by the English courts in Daisy Tek and related cases.

The conflict which is demonstrated by the Eurofoods proceeding is the analysis of the Eurofoods as a single company on one hand and as a member of a group of the other. Is the concept of determining the COMI of a single company outdated as most companies are multi-faceted organizations and have joint financing agreements and joint operations and employees. In a much more difficult economic climate does this review of COMI at an individual company level create additional impediments to financing. If a lender or hedge fund was requested to finance a group of ten companies, and if the lender believed COMI of each of the respective companies could be in different jurisdictions, would this in fact not detour the lender from providing the requested financing. The law of transparency and predictability appears to have impeded financing instead of the process.

MPOTEC GmbH⁶

After the European decision by European Court of Justice, the Tribunal de Commerce of Nanterre issued its opinion that MPOTEC GmbH's, centre of main interest was in France and opened a proceeding there as a foreign main proceeding. Although MPOTEC GmbH was German registered company, it was part of the French group of companies of EMTEC . The French Court found the centre of main interest was in France on the basis the headquarter functions of MPOTEC GmbH were carried out in France. Factors included the place of the meeting of the board of directors was in France, the law governing the main contracts was in France, the location of business relations with clients

⁶ MPOTEC GmbH [2006] B.C.C. 681 (Trib Gde Inst (Nanterre))

was in France, the location where the commercial policy of the group is differed is in France, the existence of prior authorization of parent company to enter into financial arrangements was in France and locations of creditors bank was in France, and centralization management of purchasing policy, of the staff, accounts and computers systems was in France.

The concept of a determination as to “head office functions” followed the prior decisions in England and Germany to determine COMI.

Is the concept of “head office functions” a standard that should be utilized in place of the presumption that the centre of main interests should be in the location of the registered office of the company of does this standard of “head office functions” invite forum shopping and lack of transparency and predictability.

ENERGOTECH SARL, RE⁷

In this proceeding the Tribunal de Commerce of Lure opened main proceedings of a Polish company which was part of a French group of companies. The same criteria as utilized in the MPOTEC GmbH proceeding were utilized. Although the Polish company had its registered office in Poland and business operations there, the French Court found the “head office functions” were proof to the contrary of COMI being at the company registered office.

The issue as above noted is the use of the concept of “head office functions” a proper standard for the determination of the COMI of a company.

⁷ Energotech Sarl, Re [2007] B.C.C. 123 (Ch)

The concept of “head office functions” followed in the two cases to open a proceeding as a main proceeding in France of company headquarters in Germany and Poland respectively would cause substantial concern for a lender to the companies.

If France is the main insolvency proceeding then the labor policies in France could adversely affect the secured creditors and other creditors in the insolvency proceeding. To guard against such consequences what will the additional lender charge and how much, what additional and collateral is required to protect the lender as to an adverse determination of COMI and what will the ultimate cost to the company be.

EUROTUNNEL FINANCE, LTD.⁸

The Paris Commercial Court in line with prior cases found COMI in France and opened main insolvency proceedings notwithstanding Eurotunnel Finance, Ltd was an English registered company with offices and operations in England.

The French Court found the centre of main interests of the company were ascertainable by third parties in France based on a number of factors. Those factors included the operational management of the Eurotunnel entities are exercised by a joint committee which is located in Paris, the registered office of the two main French companies of the group, Eurotunnel SA and France Manche are located in France, employees and assets are equally located in France, and negotiations as to its debt restructuring were conducted in Paris.

The findings in this case appear to be structured to find COMI in France. Is it a better practice to have a definite set of criteria upon which COMI is determined to provide for a predictability result.

⁸ Eurotunnel Finance Ltd. (Paris Commercial Court, 2 August 2006)

How do international lenders in major projects view a determination of COMI outside the registered office of the company. As more cases are decided are lenders due diligence costs and transaction fees going to substantially increase in order to address all potential contingences. In light of the current economic elements such projects because of additional cost and uncertainty, financing for such payments maybe no longer be available.

**BEN Q HOLDING, BV AND
BEN Q OHG⁹**

In an unreported decision, Ben Q OHG filed a voluntary insolvency petition in Munich, Germany and a provisional administrator was appointed by the Munich Court. Ben Q Holding, BV was incorporated in the Netherlands and the majority of the Dutch corporations activities were carried out in Munich. This was accomplished by the employees of Ben Q OHG who spent as much as seventy percent (70%) of their time for Ben Q Holding, BV. Ben Q Holding, BV also had employees situated in Amsterdam but mainly doing work for other group companies.

Ben Q OHG had first filed a petition in Amsterdam and two days later a petition for insolvency was filed in Munich. Both courts in Amsterdam and Munich granted interim relief as requested. Neither court decided whether the proceedings in each respective jurisdiction would be main or secondary proceedings.

The German judge called the Dutch judge and after a discussion between the courts the German judge said that he would defer to the Dutch judge as to a decision of whether the Dutch proceeding should be a main or secondary proceeding. The Dutch judge elected to have the proceeding in the Netherlands be the main proceeding.

⁹ BenQ Holding BV, Re (Unreported, February 2007) (Germany)

These proceedings highlighted the benefit of cooperation between Courts but result in a troublesome decision as to COMI that is without definition and specific findings of fact that result of which does not promote transparency and predictability.

The issue raised again here is that would a determination of COMI on a group context provide a better result than a determination of COMI for each individual company.

How would a lender or hedge fund view this result. The lender would probably determine from this decision that no predictability is possible for a determination of what jurisdiction will COMI be accorded as a main proceeding. In this case the lender or hedge fund would have to review the law in both jurisdictions and determine loan or investment decisions based on a worst case scenario. If one jurisdiction is more restrictive or has greater priorities then the loan that could be made or investment would be reduced accordingly. Does not the lack of predictability and certainty result in a contraction of credit rather than an expansion of credit to the respective companies.

DECISIONS UNDER THE MODEL LAW

As noted above, fourteen countries have now enacted the Model Law with other countries considering to enact the Model Law. A substantial body of case law has been developed in the United States since the enactment of Chapter 15 (the Model Law) of the U.S. Bankruptcy code in 2005 deciding and interpreting the provisions of the Model Law especially as the same relate to COMI.

IN RE TRADEX SWISS A6¹⁰

¹⁰ In re Tradex Swiss AG, 384 B.R. 34 (Bankr.D.Mass. 2008)

Tradex was a company whose registered office was in Switzerland but had an office in Boston, Massachusetts. Prior to the insolvency of Tradex the operations of the company were transferred from Switzerland to Boston. The primary business operation of the debtor then operated out of Boston. Tradex was an interest based foreign exchange trading company.

Prior to an insolvency filing, the Swiss Federal Banking Commission appointed two examiners to investigate Tradex based upon allegations Tradex was converting investor's deposits. An involuntary Chapter 7 proceeding was filed by employees against Tradex in Boston. Tradex had at that time eighteen employees in Boston and two in Switzerland. The Swiss examiners objected to the filing of the insolvency Chapter 7 and further requested relief under Chapter 15 seeking a determination that COMI was in Switzerland. The Court found the registered office of Tradex was in Switzerland but the presumption was overcome by the evidence as to the operations of Tradex in Boston. The Court did find Switzerland was a non-main proceeding but that Tradex had an establishment in Switzerland.

This result appears to be definitive as to a determination of main and non-main proceeding as to the debtor, COMI and establishment.

SPHINX MANAGED FUTURES FUND, LTD¹¹

One of the initial cases filed under Chapter 15 was filed by Sphinx, Ltd. Its petition for recognition under Chapter 15 was filed on July 31, 2006 by the joint official liquidators of Sphinx Managed Futures Fund, STC. The official joint liquidators were acting under the supervision of the Grand Court of the Cayman Islands. After a contested

¹¹ In re SPhinX, Ltd., 351 B.R. 103 (Bankr.S.D.N.Y. Sep 06, 2006)

hearing on August 16, 2006, the court granted the Chapter 15 petition in part, denied the petition in part and further took the matter under advisement.

The court found that the Cayman Islands proceeding in which the joint official liquidators were appointed, should be recognized as a “foreign proceeding” but took under advisement whether the proceeding should be recognized as a foreign main proceeding or a foreign non main proceeding. The court ultimately found that the Sphinx, Ltd. funds were hedge funds whose business consisted of buying and selling securities and commodities. Sphinx, Ltd. Registered office was in the Cayman Islands. The evidence was that Sphinx, Ltd. was incorporated as an excepted business under Cayman Island law and as a result Sphinx funds could not conduct any trade or business in the Cayman Islands. The court further found Sphinx, Ltd. had no employees or physical offices in the Cayman Islands. The court found the Sphinx, Ltd. funds was a hedge funds business conducted under a fully discretionary investment management contract with a Delaware corporation located in New York City. The court found that Chapter 15 replaced section 304 of the bankruptcy code and that Chapter 15 maintains the continuing concept of comity from Section 304 and in some respect enhances the maximum flexibility standard that was provided by section 304 in light of the principles supporting a concept of COMI and the ability to respect the laws and judgments of other nations. The court noted in its opinion that the real dispute was whether the Cayman Islands proceedings should be recognized as a foreign main proceeding or a foreign non-main proceeding. The court noted that the Cayman Island proceedings are presumed under Article 16, paragraph 3, to be foreign main proceeding. The Court noted the recent opinion by the European Court of Justice in the Eurofoods case that one of the factors to

be utilized in determining the COMI of a debtor is to determine the place where the debtor conducts the administration of his business on a regular basis and that location is therefore ascertainable by third parties. Based on the evidence presented the court granted the Chapter 15 petition for recognition as a foreign non-main proceeding. The decision by the court in Sphinx, Ltd. was highly criticized by many academics and practitioners for the utilization of comity a basis for granting recognition as a foreign non-main proceeding. Criticism centered around the concept that the Model Law was developed to promote transparency and predictability and deviated from the statutory requirements frustrates that objective. Criticism also centered around the fact that the evidence was not sufficient to find Sphinx, Ltd. a “foreign proceeding,” a “foreign main proceeding” or a “foreign non-main proceeding” and therefore recognition should have been denied. The basic concept was that recognition must be upon a jurisdictional and statutory basis under the Model Law rather than on a common law concept such as comity.

Was to Sphinx case correctly decided or was to criticism of the use of comity justified. Should comity be considered prior to the primary determination by the court of whether the foreign proceeding has been established and in consideration of whether the proceeding is a main or non-main proceeding. If comity is used as a factor will predictability and transparency be sacrificed.

TRI-CONTINENTAL EXCHANGE LTD¹²

This proceeding involved a company formed under the laws of St. Vincent and the Grenadines. A petition was filed seeking recognition of the debtor insurance

¹² In re Tri-Continental, 349 B.R. 627 (Bankr.E.D.Cal. 2006)

companies insolvency proceeding in St. Vincent and the Grenadines as a foreign “non main proceeding” by a creditor.

Proceedings were filed in the Eastern Caribbean Supreme Court to wind up Tri-Continental Exchange Ltd and Alternative Exchange, Ltd and joint provisional liquidators were appointed. The debtor’s only offices were located in Kingston, St. Vincent. The debtors conducted an insurance scam and generated premiums from customers in the United States and Canadian of over forty-five million dollars. The United States seized about one million six hundred thousand dollars and which the joint liquidators requested to be turned over in the Chapter 15 petition.

After contested hearings, the court granted recognition to the provisional liquidators and found the St. Vincent proceedings were main proceedings. The evidence before the court was the operations were in St. Vincent and was its only operations. The court granted turnover of funds to the provisional liquidators but maintained the funds in the United States for further determination as to distribution.

**BEAR STEARNS HIGH GRADE STRUCTURED CREDIT STRATEGIES
MASTER FUNDS LTD.**¹³

The issues addressed in the Sphinx, Ltd. decision were revisited in the Bear Stearns. There, the joint provisional liquidators from the Cayman Islands filed a Chapter 15 petition for recognition either as a foreign main proceeding or a foreign non-main proceeding. The petition for recognition under Chapter 15 was not contested, and after

¹³ In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 389 B.R. 325 (Bankr.S.D.N.Y. May 27, 2008); in re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122 (Bankr.S.D.N.Y. Sep 5, 2007); *see also* BEAR STEARNS APPEAL DECISION, 17 J. Bankr. L. & Prac. 5 Art. 3, Glosband (August 2008)

an evidentiary hearing the court found that the evidence before it was not sufficient to establish recognition and therefore was denied.

The facts elicited were similar to the Sphinx, Ltd. proceeding in that Bear Stearns was an exempted company not allowed to conduct trade or business in the Cayman Islands. The court found the investment activities of Bear Stearns were conducted primarily in the United States in New York. The decision was appealed to the United States District Court. After a hearing, the lower court was affirmed. The official liquidators were argued on appeal that the presumption under Article 16, paragraph 3, of Chapter 15 provided that the centre of main interests of the debtor should be the registered office and evidence to the contrary was not provided. As a result, the petition for recognition should have been granted. The district court found that a judge has an independent duty of inquiry on any matter before the court.

In this case this District Court found that the lower court correctly reviewed and analyzed independently whether the evidentiary basis for recognition should have been granted and whether the presumption had been rebutted by the evidence before the lower court. The District Court agreed with the lower court's findings that Bear Stearns did not have an office or employees in the Cayman Islands and was not able to conduct business activity in the Cayman Islands as an exempted company. The court found the centre of the main interests of Bear Stearns was the United States based upon the trading and transactional activity which occurred. The Court further found that the petition for recognition as a foreign non main proceeding should be denied as Bear Stearns did not have an establishment in the Cayman Islands. Establishment consists of a location where non transitory economic activity is conducted. The court found specifically no such

activity occurred in the Cayman Islands based upon the above factors and further that Bear Stearns did not have an establishment in the Cayman Islands.

The decision by the district court in Bear Stearns is recognized as having overturned the opinion in the Sphinx, Ltd. proceedings. The jurisprudence in the United States under Chapter 15 at this point in time supports the proposition that the statutory and jurisdiction requirements as to foreign main proceeding, foreign non main proceeding and establishment must be clearly established by clear and convincing evidence before relief can be granted. Some academics and practitioners have criticized the Bear Stearns opinions in arguing that comity should be a factor in determining the granting or denial of a petition for recognition under Chapter 15.

Inasmuch as an objective of both the European regulation and the Model Law to provide for transparency and predictability and to restrict the use of forum shopping in cross-boarder insolvency proceedings, such criticism appears contrary to the existing jurisprudence.

As noted above, the ongoing jurisprudence as developed should address the issues of comity, forum shopping, and a determination of how COMI is to be decided which would assist in establishing predictable and transparent results.

The issue will be whether Working Group V of UNCITRAL can develop a definition of COMI to provide guidance and clarification. The European Union will be addressing a similar issue in 2010 when the European Union begins an overall review of its insolvency provision. The issue of developing a definition of COMI has been addressed by both the European Union and UNCITRAL before, but the issue is a

complex one and to arrive at a consensus will be an ongoing challenge for both organizations.

BASIS YIELD ALPHA MASTER¹⁴

In this Chapter 15 proceeding, joint provisional liquidators for a debtor whose registered office was in the Cayman Islands sought a determination that the Cayman Islands was the debtors centre of its main interest. As such the provisional liquidators asked the U.S. Court to determine the Cayman Islands proceeding was a foreign main proceeding.

Counsel for the provisional liquidation sought a determination that based upon the presumption the registered office in the Cayman Islands was the COMI of the debtor relief should be granted and recognition provided. The court in its opinion stated issues of material fact precluded a reorganization order being granted. The court found the company was an exempted company and could not conduct business on the island and that business was mainly conducted outside the islands. This opinion follows Bear Stearns as to the criteria for recognition and that the court is to independently determine whether relief should be granted.

IN RE ERNST & YOUNG, INC (KLYTIE'S)¹⁵

Klytie's involved both Canadian and U.S. companies. Eighty percent (80%) owners of Klytie's business were Israeli citizens who had lived in Canada but currently live in California and the other twenty percent (20%) owners of Klytie's was a Colorado resident.

¹⁴ In re Basis Yield Alpha Fund (Master), 381 B.R. 37 (Bankr.S.D.N.Y. 2008)

¹⁵ In re Ernst & Young, Inc., 383 B.R. 773 (Bankr.D.Colo. 2008)

Klytie's was accused of defrauding investors in a real estate investment fund business of millions of dollars. After various litigation ensued, the Canadian court appointed the firm of Ernst & Young as receivers of the Canadian company.

The receivers filed a petition under Chapter 15 for recognition which was opposed by creditors from the United States. The creditors argued the administrative costs were higher in Canada and less funds would be received by creditors than if the main proceeding was conducted in the United States.

The United States court granted recognition and found the Canadian proceeding was the main proceeding as the centre of main interests of Klytie's was in Canada. The court based its opinion on evidence that the principals of the company directed affairs from Canada, the creditors understood the company operated in Canada, the main assets of the company were in Canada and the cash management system was in Canada.

The court further found based upon the statutory provisions of Chapter 15 the goal of Chapter 15 was to facilitate cooperation between the U.S. courts and courts of foreign countries. The findings are consistent with the Model Law and the decision of the court was based on a statutory analysis and determination.

The scope and extent of the current financial crisis is acknowledged as severe and worst economic downturn in modern history. As a consequence credit markets have tightened or ceased lending. Extension of credit by lenders are carefully scrutinized and profitability and asset quality are carefully reviewed. In this new and challenging economic environment the extension of credit is a critical component by most businesses. That must be considered in evaluating any such loan extension. The lack of predictability and transparency as to a company COMI will greatly increase the cost of the credit or be

a basis to deny the requested extension of credit. Decisions such as Bear Stearns provides a statutory basis upon which lenders can rely which is predictable and transparent and assists in the determination of COMI on a more precise basis and address issues of forum shopping.

ISSUES TO BE ADDRESSED

The focus of this presentation is to discuss alternatives to Chapter 15 especially in light of the Bear Stearns decision. The initial matter that needs to be addressed is what is the relief that is being sought and why. The relief being sought is different based upon who is making the request.

In the case of secured creditors, the relief sought is generally a recognition of its security interests and a validation of its indebtedness with the ability to enforce its contractual obligations. In the event of liquidation, the secured creditor wants to recover its collateral and apply the recoveries to its outstanding indebtedness. In Chapter 15 proceedings, secured creditors can be adversely affected based upon the determination of the location of the centre of main interest (“COMI”) of the debtor. Thus, if a lender who has advanced funds in the United States or in the United Kingdom is subject to the filing of an insolvency proceeding in a country that has laws strongly supportive of employees and labor, the secured creditor’s position can be substantially altered or subordinated. The issue here will vary as to where the collateral is located that the secured creditor is trying to recover or to enforce its security interest. If the collateral is real property located in a jurisdiction such as the United States or United Kingdom then the results may be substantially at variance if that collateral is located in France, Italy or in many South American countries.

Another constituency is unsecured creditors and the initial issue to be considered is whether existing Chapter 15 decisions have adversely affected the rights of unsecured creditors. Priorities in different jurisdictions can have an impact on how unsecured creditors are treated. The rights of unsecured creditors are subject to the location in which the creditor conducts business and whether the assets of the debtor can be attached in order to effectuate a recovery of the amounts due to that creditor. If the creditor is a Swiss creditor and there are assets situated in Switzerland then under Swiss Law any ancillary or secondary proceeding that occurs will be subject to Swiss Law which provides that Swiss creditors must be paid first prior to any funds being paid to any other non-Swiss creditor either in Switzerland or outside the country. Thus, the location where an unsecured creditor extends credit and engages in business operations may well determine that the creditors ability to recover the indebtedness due or a portion thereof based upon the laws of that specific jurisdiction. An unsecured creditor can choose the jurisdictions in which it engages in business transactions and to what extent credit on an open account is granted or if a letter of credit is to be drawn upon shipment of the goods being sold.

The next constituency is the debtor. A company or business that experiences financial difficulties wants to be able to best utilize existing insolvency laws in order to restructure its debt or to effectuate a reorganization of the company. The debtor, in the absence of an involuntary proceeding, has the initial choice of location as to the filing of an insolvency proceeding and to choose the jurisdiction which is most appropriate for that debtors business purpose. Other factors which are considered as part of the process and are relevant is whether one countries laws are more favorable from a liability standpoint in the event of an insolvency proceeding. Thus to place that abstract concept

into more definitive terms if a hedge fund has conducted the majority of its business in the United States but has its registered office in the Cayman Islands and as a result of various business transactions becomes insolvent, then one of the considerations for the debtor to consider is whether Cayman Laws are more favorable in regard to causes of action against the debtor and its principals than would be actions under U.S. Law.

One issue to be further considered is under Chapter 15 if, recognition is granted by a U.S. Court to a Cayman Islands proceeding and the determination the Cayman proceeding is the centre of main interest, would this restrict individual investors from pursuing officers, directors and professionals under U.S. law as opposed to Cayman Law.

When analyzing whether Chapter 15 has been adequate in regard to proceedings sought by Cayman Island liquidators in the United States, the purpose and intent of why recognition is requested must be considered.

OTHER ALTERNATIVE STRUCTURES

In British or British related jurisdictions the Winding Up Act has been a primary vehicle as opposed to insolvency proceedings to liquidate companies that can no longer continue their own business operations. As part of the proceedings, the debt and perfection of the secured creditor is usually determined and unless there is equity for the remaining creditors, the secured creditor is allowed to pursue and liquidate its collateral. Once that determination has been made as to perfection and validity then if an insolvency proceeding is filed the insolvency representative or the Trustee as the case may be, unless there is separate statutory provision of the insolvency law such as a preference on fraudulent conveyance action, the secured creditor will be able to proceed to obtain its collateral. As such a Chapter 15 proceeding may in fact be overridden or superseded by

the prior determinations previously made on behalf of its secured creditor. Some jurisdictions also have legally determined that upon a receiver being appointed and physically taking possession of the assets that the assets are no longer property of the debtor in that the property of the debtor has been conveyed to the receiver.

SUMMARY

The issues that have been addressed are complex and much debated. Arguments have been made that comity should be utilized and supersede the Model Law on Cross-Border Insolvency and its related prodigy Chapter 15 in the United States. If trade and commerce is to be promoted then predictability, transparency and consistency are elements which are required. The business purpose in each individual case must be carefully reviewed to determine whether that cause of action is appropriate for relief and must be balanced in light of the rights of the secured creditors, unsecured creditors and the debtor in arriving at a final decision and determination.